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Supreme Court of the United States

OCTOBER TERM, 1954

No. 305

ESTATE OF IDA S. GODLEY, Deceased, PAUL F. GODLEY and JOHN W. YOUNG, JR., Co-Executors,
Petitioners,

—against—

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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IN THE

Supreme Court of the United States

October Term, 1954

No.

ESTATE OF IDA S. GODLEY, Deceased, PAUL F. GODLEY and JOHN W. YOUNG, JR., Co-Executors,

Petitioners,

against

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

To the Honorable the Chief Justice of the United States and the Associate Justices of the Supreme Court of the United States:

Petitioners respectfully pray that a Writ of Certiorari be issued to review the judgment of the United States Court of Appeals for the Third Circuit, entered May 28, 1954 (a copy of which judgment is appended hereto as Appendix "B"), reversing a decision of the Tax Court of the United States, rendered on May 18, 1953. The Tax Court had reviewed and overruled Respondent's determination of a deficiency in the Federal income tax of Petitioners' decedent for the taxable year 1947. The opinion of the United States Court of Appeals for the Third Circuit (a copy of which

opinion is appended hereto as Appendix "A"), delivered upon rendition of its judgment, is reported in 213 F. 2d 529 (1954). The opinion of the Tax Court is reported in 19 T. C. 1082 (1953), and is set forth in the appendix record (Rec. 3a).

Grounds of Jurisdiction

The judgment of the United States Court of Appeals for the Third Circuit, rendered on May 28, 1954, was entered on the same date. Jurisdiction of this Court is invoked under Title 28 of the United States Code, Section 1254(1).

Question Presented

The extent to which a distribution by a corporation to its stockholders of property which has appreciated in value in the hands of the corporation is taxable to the stockholders as a dividend, where the earnings or profits of the corporation exceed the cost to it of the distributed property but are less than the fair market value of the property at the time of distribution.

Statutes and Regulations Involved

This case involves the following statutes and regulations:

Sections 115(a), (b), (d) and (j) of the Internal Revenue Code of 1939 (26 U. S. C. 1946 ed.);

Treasury Regulations 111, Sections 29.115-1, 29.115-2 and 29.115-4, promulgated under the Internal Revenue Code of 1939.

The said Statutes and Regulations are set forth in Appendix "C".

STATEMENT OF THE CASE

In 1947 Southern Natural Gas Company, a Delaware corporation, distributed to its stockholders four cash dividends of 37½ cents each on March 12, June 12, September 12 and December 12 of that year (Rec. 21a, 27a) and on July 28, 1947, distributed one share of stock of Southern Production Company, Inc. for each share of stock of Southern Natural Gas Company outstanding (*ibid.*) The cash dividends totaled $2,113,722.03. The cost of the stock of Southern Production Company, Inc. to Southern Natural Gas Company was $3,199,950 and its fair market value was $8,983,407.75; the appreciation in value over cost was $5,783,457.75.

For tax purposes, the earnings or profits of Southern Natural Gas Company available for dividends in 1947 amounted to $5,674,586.32 (29a). Accordingly, the cash and property distributed in 1947 to stockholders exceeded in value by $5,422,543.46 the amount of earnings or profits available for taxable dividends.

According to the books of Southern Natural Gas Company, its earned surplus on December 31, 1946 was $14,106,850.03. Its net income for the year 1947 was $3,226,156.79 and the book earned surplus at the end of the year 1947, before deducting dividends on the common stock, was $17,669,983.23 (23a). Southern Natural Gas Company charged its distribution of Southern Production Company, Inc. stock against earned surplus at cost and after deducting the cost of the stock ($3,199,950) and the cash distributions of $2,133,722.03, its book earned surplus on December 31, 1947 was $12,356,597.65.

On September 11, 1947 Southern Natural Gas Company wrote a preliminary letter to its stockholders stating that when more definite information was available with respect to the taxable status of dividends paid during 1947, the stockholders would be advised (27a). On February 20, 1948, it advised that no more definite information was available and it stated two alternative methods of reporting recommended by its tax consultant (27a). Under the method which was based upon the assumption that the tax surplus of the company at December 31, 1946 was not subject to reduction by reason of the deficit of a predecessor company, the estimate was that, of the total distributions of $7.875 per share, the cash distributions of March 12, 1947 and June 12, 1947 were fully taxable; the stock distribution of July 28, 1947 was taxable to the extent of $2.855 per share, and the cash distributions of September 12 and December 12, 1947 were taxable to the extent of $.095 per share.

On March 25, 1952, E. I. McLarney, Deputy Commissioner of Internal Revenue, sent to Southern Natural Gas Company a letter stating that the taxable status of the dividend distributions totaling $7.875 per share in cash and property had been determined to be 100% taxable as follows:

> "51.13562% or $4.027 as ordinary dividends, and 48.86438% or $3.848 as other income" (28a).

The computation of earnings or profits made by the Treasury Department, and which accompanied this letter, showed that earnings or profits available for dividends for the year 1947 amounted to $2,936,819.51 and the accumulated earnings or profits as of January 1, 1947 amounted to $2,737,766.81 (29a).

The stipulated facts show that this wide difference between earned surplus according to the books and accumulated earnings or profits for tax purposes, was due principally to different methods of treating depreciation and accelerated amortization under Section 124 of the Code. Mr. McLarney's letter summarized his findings as follows:

"Dividends paid in 1947

Cash $1.50 per share or	$ 2,113,722.03
Property $6.375 per share (Cost)	3,199,950.00
	$ 5,313,672.03
Appreciation	5,783,457.75
Total	$11,097,129.78"

The letter continued: "Since the available earnings exceed the cash and cost of property distributed, the entire distribution to the extent of the available earnings is held 51.13562% taxable as an ordinary dividend and the balance is held taxable to the shareholders as other income." The theory of this letter apparently was that the distributions were dividends to the extent that the cash and fair market value of the property were covered by earnings or profits but that the excess over earnings or profits was taxable under Section 22(a) as other income.

Ida S. Godley, a resident of New Jersey, was the owner of 200 shares of stock of Southern Natural Gas Company during the entire year 1947. She received cash distributions aggregating $300 and 200 shares of common stock of Southern Production Company, Inc. In her income tax return for the year 1946, she included the distributions received by her as taxable to the extent of $740.25 (22a). The Commissioner determined a deficiency, and she filed a

petition for review in the Tax Court on June 8, 1951. She died in 1952, and her executors have carried on the proceeding (2a). The facts were stipulated, and a hearing was held before Judge Hill on June 25, 1952. In the Tax Court the contention (which was foreshadowed by Mr. McLarney's letter) that the excess over earnings or profits was taxable as "other income", was urged as an alternative if the Court did not accept the primary contention that, since the cost of the asset was covered by earnings or profits, the distribution was a dividend which was valued in the hands of the stockholders at fair market value under Section 115(j). The opinion of the Tax Court dealt with both points. Its decision held that the distributions were taxable to the extent covered by earnings or profits and the excess was applicable to reduce basis under Section 115(d). The Commissioner petitioned for review to the Court of Appeals for the Third Circuit. The case was argued on February 16, 1954. Its decision was rendered on May 28, 1954, after the Court of Appeals for the Second Circuit decided the case of *Commissioner* v. *Hirshon Trust*, 213 F. 2d 523 (2d Cir. 1954). The *Hirshon* case had been decided in the Tax Court on the authority of the *Godley* case. P-H 1953 T. C. Mem. Dec. ¶53,106 (1953).

REASONS FOR GRANTING WRIT OF CERTIORARI

1. The question whether under the Internal Revenue Code of 1939 a property distribution by a corporation is taxable to its stockholders at fair market value or at fair market value limited by the earnings or profits available is one of general importance and should be settled by this Court.

Under the decision of the Court below, a distribution is taxable at fair market value if earnings or profits are

sufficient to cover the cost of the asset distributed. This means that every time a property distribution is made, the cost of the asset distributed is charged against earnings or profits, instead of fair market value. If the cost of the asset distributed is not covered by earnings or profits, it will be necessary to have new litigation to determine whether the property received is taxable at fair market value or at fair market value less the excess of cost over earnings or profits.

Under Treasury Regulations 111, Sec. 29.115-2, it is necessary to prorate all distributions during the year against the earnings or profits of the taxable year and then apply accumulated earnings or profits against distributions in the order in which made until the accumulations are exhausted. Accordingly, in every case where a property distribution and cash distributions are made in the same year, the question whether cost or fair market value should be charged against earnings or profits affects the taxability of the cash distributions as well as the property distribution.

The question whether the fair market value of the asset distributed must be covered by earnings or profits in order to be taxable to stockholders at fair market value also arises in connection with bargain sales to stockholders, under *Palmer* v. *Commissioner,* 302 U. S. 63 (1937) and Sec. 29.22(a)(1) of Regulations 111; as to property distributed as boot in connection with reorganizations, under Regulations 111, Sec. 29.112(g)(5); and in connection with redemptions of stock under conditions making redemption substantially equivalent to a taxable dividend, under Internal Revenue Code of 1939, Sec. 115(g).

The reason that there has not been more litigation on the question whether it is necessary to have the fair market

value of the asset covered by earnings or profits is that the Commissioner agreed that such coverage was necessary. The Commissioner's argument in *Young* v. *Commissioner*, 103 F. 2d 137 (3d Cir. 1939), was based upon the proposition that the fair market value of an asset distributed was a dividend only to the extent of the earnings or profits of the corporation.

The second ground of decision in the Court of Appeals in *Binzel* v. *Commissioner*, 75 F. 2d 989 (2d Cir.), *cert. denied*, 296 U. S. 579 (1935), was that if earnings or profits were sufficient to cover the fair market value of the asset distributed, the distribution was a dividend in accordance with its fair market value and the amount of the appreciation could not be applied to reduce basis. This ground was urged by the Commissioner to this Court in its opposition to the application for certiorari which was made to this Court by the taxpayer.

The distribution in the case at bar was made in 1947. The Commissioner published his non-acquiescence with the decision of the Tax Court in *Paulina DuPont Dean*, 9 T. C. 256 (1947), in 1947-2 Cum. Bull. 6. This non-acquiescence states:

> "Non-acquiescence relates only to the issue whether appreciation in value of asset distributed in kind is includable in computing earnings and profits of the corporation which made the distribution."

This contention of the Commissioner is entirely consistent with the Commissioner's view that, except to the extent that fair market value is covered by earnings or profits, it is not a dividend. The Commissioner's contention was that earnings and profits should be increased, in order to satisfy

this requirement, by the appreciation in value of the asset distributed.

In 1950, an article was published in the Harvard Law Review, entitled *"Dividends in Kind: Their Tax Aspects"*, 63 Harv. L. Rev. 593, which was written by Leonard Raum, an attorney in the office of the Chief Counsel of the Bureau of Internal Revenue. The article was reprinted with revisions in the Proceedings of the Ninth Annual Institute on Federal Taxation (New York University) 1029 (1951). This article sets forth a revolutionary interpretation of Section 115(a), (b) and (j) and ignores Section 115(d). The article interprets Sections 115(a) and 115(b) as "in effect" providing:

> "that any distribution which is not made out of capital is a dividend".

It then demonstrates that a property distribution in appreciated property where the cost of the asset is covered by earnings or profits does not impair the paid-in capital of the corporation. In line with this philosophy, Mr. Raum's contention was to the effect that earnings or profits for income tax purposes did not measure the extent that distributions were dividends, but merely distinguished distributions which were out of surplus from those out of capital. Under Mr. Raum's interpretation of the law earnings or profits for dividend purposes have substantially the same meaning as an earnings or profits test by which the laws of some states determine the legality of dividends.

Mr. Raum's article has now been carried into law in the Second and Third Circuits by the decisions in the *Hirshon* and *Godley* cases. Unless this Court intervenes by granting certiorari, it is inevitable that there will arise numerous cases seeking to apply the new approach and the principles

which Mr. Raum suggests. It would seem from the two opinions that in a case where earnings or profits are insufficient to cover cost, a different result might be reached in the Second Circuit from the one reached in the Third Circuit. The Court of Appeals for the Second Circuit held broadly that Congress intended to tax as ordinary income any distribution which was not out of capital. Accordingly, under this rule, a property distribution in the case where earnings or profits were insufficient to cover cost, would nevertheless presumably be taxable to the extent of the earnings or profits available plus the appreciation in value of the asset distributed.

The Court of Appeals for the Third Circuit adopted the negative bookkeeping approach suggested by Mr. Raum, and gave no reason for its conclusion that the appreciation in value of an asset, which was out of earnings or profits only to the extent of cost, should be taxed to stockholders as ordinary income, except to state that Section 115(j) would be meaningless otherwise.

The bookkeeping approach of the Third Circuit must necessarily produce great confusion in the future. It is futile to attempt to reconcile earnings or profits for tax purposes with earned surplus according to the books. In the present case, the difference between earnings or profits for income tax purposes and earned surplus according to the books was over $12,000,000. A clarification of the relation, if any, between book accounting and tax accounting is greatly needed in the administration of the Internal Revenue Code.

Moreover, the fact that the Court below interpreted Section 115(a), (b) and (j) (it did not interpret Section 115(d)) differently from the interpretation placed upon

these provisions by the framers of the Internal Revenue Code of 1954 is of importance. It is settled that "subsequent legislation may be considered to assist in the interpretation of prior legislation upon the same subject." *Great Northern Ry. Co.* v. *United States,* 315 U. S. 262 (1942), quoting from *Tiger* v. *Western Investment Co.,* 221 U. S. 286, 309 (1911).

The Ways and Means Committee of the House interpreted the 1954 Code as carrying out the provisions of the 1939 Code relating to the taxability of property distributions to stockholders. The House Committee said (H. R. Rep. No. 1337, 83d Cong. 2d Sess., p. 37):

> "In general, the rules of present law are retained with respect to current distributions by a corporation to its shareholders. Thus, the amount of a distribution is the amount of money or the fair market value of any securities or property distributed and as under present law, a shareholder, other than a corporation, is taxed at ordinary income rates on the fair market value of property distributed to the extent of the earnings and profits of the distributing corporation. Similarly, to the extent the distribution is not out of earnings and profits, it reduces the basis of the stock on which the distribution is made and any excess is taxable at capital gain rate."

In a detailed discussion of the provisions of the new Code, it was said that they represent generally a restatement of existing law under Sections 115(a), (b), (d), (e) and (j) (H. R. Rep. No. 1337, *supra,* at p. A70).

Cf. the Report of the Senate Finance Committee, Sen. Rep. No. 1622, 83d Cong. 2d Sess., pp. 46, 248.

2. The decision of the Court below is in probable conflict with this Court's decision in *Palmer* v. *Commissioner*, 302 U. S. 63 (1937).

In *Palmer* v. *Commissioner*, 302 U. S. 63 (1937), the question was whether a stockholder was taxable on the exercise of a right to subscribe to stock of another corporation which at the time of the exercise of the subscription right had a fair market value in excess of the subscription price. This Court dealt with the question whether the sale of a corporate asset to stockholders could be treated as a taxable dividend. It held (*id.* at p. 69) that a sale to stockholders which did not result in any diminution of its net worth would not result in a distribution of its profits. On the other hand, the Court said:

> "* * * Such a sale, if for substantially less than the value of the property sold, may be as effective a means of distributing profits among stockholders as the formal declaration of a dividend."

When a corporation sells assets to its stockholders at cost, it does not reduce its net worth according to the books if the asset is carried on the books at cost. From a book standpoint, earned surplus is not affected. There is merely a substitution of cash on the asset side of the balance sheet for the cost of the asset sold.

Again, it is possible for a corporation to sell to its stockholders an asset which had a fair market value at the time of sale in excess of the price at which it is offered to stockholders, but which nevertheless was less than the cost of the asset to the corporation. From the standpoint of the stockholders it is clear under *Palmer* v. *Commissioner*, *supra*, that there has been a distribution of available earn-

ings or profits to the extent of the difference between the fair market value of the asset sold and the price charged to the stockholders.

From the standpoint of the corporate books, however, earned surplus is reduced by the difference between the cost to the corporation of the asset and the price received from the stockholders.

Regulations 111, Sec. 29.22(a)(1), carry into effect the decision of this Court in *Palmer* v. *Commissioner, supra.* It is provided:

> "If property is transferred by a corporation to a shareholder, for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, such shareholder shall include in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of a distribution of earnings or profits taxable as a dividend."

In order to carry out this Regulation and the decision of this Court in *Palmer* v. *Commissioner, supra,* it is necessary to disregard the effect of the distribution upon earned surplus according to the books in determining whether there has been a distribution of earnings or profits for tax purposes.

The decision of the court below to the effect that the property distribution could not distribute earnings or profits in excess of the cost of the asset to the corporation is probably in conflict with *Palmer* v. *Commissioner,* 302 U. S. 63 (1937).

3. The decision of the Court below is in conflict with the decision of the Court of Appeals for the Sixth Circuit in *Commissioner* v. *Timken*, 141 F. 2d 625 (6th Cir. 1944).

The decision in the *Timken* case was rendered at a time when the Commissioner was contending that earnings or profits available for dividends should be increased by the amount of the appreciation in value of the asset distributed. Since the Court below recognized that earnings or profits were not increased by the amount of the appreication it may be said that its decision is not inconsistent with the *Timken* case.

But the Court in the *Timken* case also had Section 115(j) before it. There was necessarily involved, therefore, in the *Timken* case the question whether Section 115(j) taxed the appreciation.

In the *Timken* case the cash and fair market value of the property distribution were held taxable to the stockholder only to the extent that these distributions represented earnings or profits and the difference between earnings or profits and the amount received by the stockholder was held applicable to reduce the basis at which he held his stock. The opinion of the Court of Appeals in the *Timken* case erroneously states that the property distribution was out of capital because, at the time the distribution was made, previous cash distributions had exhausted earnings or profits. Under the Revenue Act of 1936, it was necessary to determine the coverage of earnings or profits with respect to all distributions made during the year. It was impossible to say at the time of the property distribution that previous cash distributions in the same year had exhausted earnings or profits. The Commissioner assessed

the tax, as appears from the opinion of the Board of Tax Appeals (47 B. T. A. 494, at 517), by finding that the cash and property distributions were covered by earnings or profits to the extent of 88.58% (taking the property distribution at cost).

Conclusion

It is submitted that the question involved is one of general public importance, that the decision of the United States Court of Appeals for the Third Circuit is in apparent conflict with the principles of tax law enunciated in decisions of this Court and other Courts of Appeals, and that the question is therefore one which should be resolved by this Court.

Wherefore, Petitioners respectfully pray that a Writ of Certiorari be issued by this Court to review the judgment of the United States Court of Appeals for the Third Circuit.

Respectfully submitted,

ALLEN S. HUBBARD,
JOHN WESTBROOK FAGER,
NORMAN THOMAS GILROY, JR.,
Attorneys for Petitioners.

APPENDIX "A"

The following is the full text of the opinion of the Court of Appeals for the Third Circuit in the instant case:

"UNITED STATES COURT OF APPEALS

FOR THE THIRD CIRCUIT

No. 11,202

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

ESTATE OF IDA S. GODLEY, DECEASED,
PAUL F. GODLEY AND JOHN W. YOUNG, JR.,
CO-EXECUTORS,
Respondents.

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

Argued February 16, 1954

Before MARIS, KALODNER and STALEY, *Circuit Judges.*

OPINION OF THE COURT

(Filed May 28, 1954)

By STALEY, *Circuit Judge.*

The Commissioner petitions for review of a decision of the Tax Court. 19 T.C. 1082 (1953). The facts were stipulated and were found accordingly. We will attempt to state them generally so that this opinion does not become a welter of figures.

Respondents' decedent held stock of the Southern Natural Gas Company. In 1947 she and the other shareholders of the gas company received a distribution partly in cash and partly in property. The property consisted of shares of stock of the Southern Production Company, Inc., which had been held by the gas company. The production company stock had been acquired by the gas company at a cost of $3,199,950. At the time of distribution, its fair market value was $8,983,407.75. The total cash distribution by the gas company was $2,113,722.03, making the total of the cash and property received by the shareholders $11,097,129.78. At the time of distribution, the gas company had available for dividends earnings or profits totaling $5,674,586.32. The footnote contains a tabular account of the arithmetic of what happened.[1] The decedent treated roughly half of what she received from the gas company as ordinary income for the year 1947. The Commissioner's deficiency assessment held her total receipts from the gas company to be taxable as ordinary income. Respondents were successful in the Tax Court, and the case comes here.

Forgetting for the moment the cash distribution, the case amounts to this, when reduced to its essentials. A

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[1]

Total earnings and profits available for 1947 dividends		$5,674,586.32
Distributions charged out by Southern		
Cash $1.50 per share	$2,113,722.03	
Property $6.375 per share cost	3,199,950.00	
Total charged out by corporation per books	$5,313,672.03	
Distributions received by stockholders		
Cash	$2,113,722.03	
Property, at fair market value	8,983,407.75	
Total received by stockholders	$11,097,129.78	

corporation made a distribution in kind to its shareholders of property whose fair market value at the time of distribution exceeded its cost to the corporation and also exceeded the corporation's earnings or profits available for dividends, when considered apart from the property's appreciation in value. The earnings or profits were, however, sufficient to cover the cost to the corporation of the property distributed. In order to decide the tax effect on the distributees, therefore, we must determine whether a distribution in kind of appreciated property reduces the distributing corporation's earnings or profits by the fair market value of the property, without addition of the increment in value, as the Tax Court held, or whether it reduces earnings or profits only by the cost of the property. The two methods produce substantially different results. If earnings or profits, without addition of the increment caused by the appreciation in value, must be matched against the fair market value of the property, the distribution will be a dividend only to the extent of earnings or profits and the distributees will be taxed on that amount only, with the excess over earnings or profits going first to reduce the basis of the shares held by the distributees and any excess over basis being taxed as a capital gain under Section 115(d).[2] This was the Tax Court's view. On the other hand, if earnings or profits, again without addition of the increment in value, must be matched against the cost of the property, the entire distribution will be a dividend and

[2] "(d) Other distributions from capital.

"If any distribution made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not a dividend, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property. . . ." 26 U.S.C. § 115(d) (1952).

the distributees will be taxed upon the full fair market value as ordinary income.

The problem acquires its setting from the following provisions of the Internal Revenue Code. By Section 22(a) " 'Gross income' includes gains, profits, and income derived from . . . dividends. . . ."[3] But Section 22(a) does not define a "dividend." For that purpose, its subsection (e)[4] directs us to Section 115. Section 115(a) defines a dividend as a corporate distribution to its shareholders "out of its earnings or profits. . . ." Section 115(b) provides a conclusive statutory presumption to the effect that every corporate distribution is "out of earnings or profits to the extent thereof. . . ." Finally, Section 115(j) values a property dividend by providing that the property received "shall be included in gross income at its fair market value. . . ."[5]

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[3] 26 *id.* § 22(a).

[4] "(e) Distributions by corporations.

"Distributions by corporations shall be taxable to the shareholders as provided in section 115." 26 *id.* § 22(e).

[5] "§ 115. Distributions by corporations—(a) Definition of dividend.

"The term 'dividend' when used in this chapter . . . means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made. . . .

"(b) Source of distributions.

"For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. . . .

"(j) Valuation of dividend.

"If the whole or any part of a dividend is paid to a shareholder in any medium other than money the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder." 26 *id.* § 115(a), (b), and (j).

The Tax Court said that the genesis of the problem was the Supreme Court's decision in General Utilities Co. v. Helvering, 296 U. S. 200 (1935). There General Utilities distributed to its shareholders property that had appreciated in value over its cost to the corporation. The Court held that General Utilities derived no taxable gain from the distribution. Because of procedural points involved and the sequence of the Commissioner's arguments before the Board of Tax Appeals, the Fourth Circuit, and the Supreme Court, the scope of the holding of the General Utilities case is uncertain.[6] There is no doubt, however, that the case has received judicial and administrative acceptance as standing for the proposition that a corporation does not realize income from the distribution of property which has appreciated in value over its cost.[7] We will so accept it for purposes of discussion here. Construing the General Utilities case as stated above, the Tax Court held that the so-called rule of that case should be applied in computing the amount of a corporation's earnings or profits available for dividends even where no question of the effect on its taxable net income was involved.[8] Therefore, the appreciation in value of the property held and distributed by the gas company here was not added to its earnings or profits. The

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[6]Paul, Ascertainment of "Earnings or Profits" for the Purpose of Determining Taxability of Corporate Distributions, 51 Harv. L. Rev. 40, 55-57 (1937).

[7]Commissioner of Internal Revenue v. Wakefield, 139 F. 2d 280 (C. A. 6, 1943); Platt Trust, 4 CCH T.C.M. 715 (1945), pet. for review dism'd, 154 F. 2d 1016 (C.A. 9, 1946); Hanan, 3 CCH T.C.M. 670 (1944); Koshland, 2 CHH T.C.M. 972 (1943). See also annotation in 7 A.L.R. 2d 750, 751 (1949).

[8]National Carbon Co., 2 T.C. 57 (1943); Estate of Timken, 47 B.T.A. 494 (1942), aff'd, 141 F. 2d 625 (C.A. 6, 1944).

result was that the distribution of the cash and property was a dividend and, thus, taxable to the distributees as ordinary income, only to the extent of the gas company's earnings or profits.

The Commissioner's contention was that earnings covered the cost of the property distributed and, therefore, the distribution was "out of earnings or profits" under 115(a) and was backed by earnings or profits "to the extent" of cost under 115(b). The distribution was, therefore, a "dividend." Having been classified as a dividend under 115(a) and (b), 115(j) then comes into operation and imposes a tax upon the distributees to the extent of the then fair market value of the property received. This argument was rejected by the Tax Court because it was said to destroy what was thought to be the proper correlation between taxability to the shareholder-distributees and the effect upon statutory earnings or profits of the corporation and because it was thought that to allow the Commissioner's argument to prevail would be to allow him to do indirectly what the Court in General Utilities prevented him from doing directly, i.e., write up the earnings or profits of the distributing corporation by the amount of the unrealized appreciation of the property distributed. We concede, of course, that the solution is not free from difficulty, but we think the Commissioner's theory has none of the effects attributed to it by the Tax Court and is the better of the two rules.

There is no statutory definition of "earnings or profits." The attempt to ascertain its meaning is usually made in a negative way. That is, there is general agreement that "earnings or profits" are not the same as tax-

able net income.[9] The General Utilities case has been accepted as another negative delineation of earnings or profits, in that it has been extended, as the Tax Court did here, as supporting the proposition that earnings or profits do not include the appreciation in value of the property distributed.[10] Furthermore, Section 115(*l*), which came into the Code in 1940, seems to support the rule that unrealized gains should not increase earnings or profits by providing that a realized but nonrecognized gain or loss shall not increase or decrease earnings or profits.[11] That section makes it clear that if a gain is not only nonrecognized but also not even realized, *a fortiori,* it should not be added to earnings or profits. *Cf.* Commissioner of Internal Revenue v. Wheeler, 324 U. S. 542 (1945). But, if the appreciation in value of the property is an unrealized gain and, thus, may not be added to earnings or profits, we think it may not be subtracted either. Prior to distribution, the corporation carries the property on its books at its adjusted cost basis, since, as we have seen, the appreciation in value of the prop-

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[9] Commissioner of Internal Revenue v. Wheeler, 324 U. S. 542, 546 (1945); U. S. Treas. Reg. 111, § 29.115-3, Earnings or profits, 26 Code Fed. Regs. § 29.115-3 (1949). See also Albrecht, "Dividends" and "Earnings or Profits," 7 Tax. L. Rev. 157, 181-196 (1952); Rudick, "Dividends" and "Earnings or Profits" under the Income Tax Law: Corporate Nonliquidating Distributions, 89 U. of Pa. L. Rev. 865, 879-889 (1941); Paul, *supra* note 6.

[10] See LaBelle Iron Works v. United States, 256 U. S. 377 (1921); Chapman v. Anderson, 11 F. Supp. 913 (S. D. N. Y. 1935).

[11] "(*l*) Effect on earnings and profits of gain or loss and of receipt of tax-free distributions.

* * * * * * *

"Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. . . ." 26 U. S. C. § 115(*l*) (1952).

erty, in the absence of a closed transaction, does not become realized income. Of course, it is quite true that the increment in value is distributed by the corporation in the sense that it inheres in the property and leaves the corporation when the property does, but its distribution does not decrease earnings or profits because it never became part of earnings or profits. If the distribution of appreciated property were a realization of income by the corporation to the extent of the increment in value, simple arithmetic would require that the distribution would cause a simultaneous increase and decrease in the earnings or profits by the amount of the appreciation. That is, fair market value could be subtracted from earnings and profits only if fair market value (made up of cost, plus appreciation) had theretofore been added to earnings and profits. The result is that cost is the only real variant and, therefore, the only real reduction in earnings or profits is to the extent of cost.

We think the correct approach to a case of a corporate distribution of appreciated property is dictated by the Code. Section 115(a) and (b) define a dividend. For purposes of characterizing a distribution as a dividend *vel non*, i.e., whether it is out of earnings or profits, the sole relevant test is from the standpoint of the distributing corporation and from that standpoint fair market value is immaterial. The amount of a distribution, once it is determined that the distribution is a dividend, is governed by 115(j) and is measured solely from the standpoint of the distributees and with reference to fair market value, and for that purpose the earnings or profits of the corporation are immaterial.[12] Nor do we think this destroys any supposed cor-

[12]See Raum, Dividends in Kind: Their Tax Aspects, 63 Harv. L. Rev. 593, 609 (1950).

relation between taxability to distributees and effect on the corporation's earnings or profits. Indeed, there can be no correlation, in terms of *amounts* of money, for tax purposes, as between what the corporation distributes and what the shareholders receive, because, by hypothesis, the corporation does not, but the distributees do, realize income to the extent of the appreciation in value of the property distributed. The only correlation possible is that taxability to the distributees correspond with the source of the distributed property in the earnings and profits of the corporation. The Tax Court's insistence that there must always be an exact correlation between the amount of dollars by which a dividend in kind affects the earnings or profits of a corporation and the amount of dollars that are taxable in the hands of the stockholder receiving the dividend renders Section 115(j) meaningless and makes of 115(a) and (b) the sections which not only determine the character and the source of the distribution but which value the distribution in the hands of the stockholder.

The following example, suggested to us by the Commissioner, shows that the result of the Tax Court's decision completely distorts the corporation's earnings or profits and its general financial picture. Assume that a corporation has $100,000 worth of capital and $12,000 of earnings or profits. It owns property which cost $10,000 but has now appreciated to $15,000. The property is distributed in kind to its shareholders. The General Utilities case is said to prevent a realization of income to the corporation of the $5,000 unearned increment and also to prevent increasing earnings or profits by the $5,000 appreciation. Now, if the $15,000 fair market value of the distributed property, which includes the $5,000 appreciation, is charged against earn-

ings or profits, there results a $3,000 deficit in that account or a reduction of capital by that amount. Really, however, the corporation's investment in the property was all that it parted with from a tax standpoint. As a matter of fact, after the distribution, the corporation's capital is not only wholly intact but it has $2,000 of earnings or profits remaining and available for future dividends. If we return to the facts of our case, we find that the Tax Court's solution causes equally unrealistic results in the gas company's earnings or profits and financial picture. After the cash distribution the gas company had $3,560,864.29 of earnings or profits available for dividends. To reduce that amount by the fair market value of the distributed property ($8,983,407.75), not only consumes all of the earnings or profits but results in a deficit in that account in the amount of $5,422,543.46 or a reduction of capital in that amount, which is a book situation altogether at odds with the facts, because in reality capital not only was still intact but there were $360,914.29 of earnings or profits left. The Tax Court's decision not only unduly limits the amount which is taxable to the shareholders as a dividend by reason of the instant distribution but removes $360,914.29 of actual earnings or profits from future taxation as a dividend on any subsequent distribution by the gas company.

We hold that upon a corporate distribution of property that has appreciated over cost but whose cost is exceeded by earnings or profits, considered without addition of the property's appreciation in value, the proper reduction of earnings or profits is to the extent of cost. Taxwise, this means that in our case the entire distribution was a "dividend" and the distributees are taxable upon the full fair market value received. We think this does no violence

either to Section 115(*l*) of the Code or to the General Utilities case, but, on the contrary, is entirely consistent with both and with what we think is required by 115(a), (b), and (j) in a case of this kind.

It must be conceded that, while we are not alone in our view, almost all the Tax Court cases have gone the other way.[13] In R. D. Merrill Co., 4 T.C. 955, 959-963 (1945), a case of a distribution in kind of depreciated property, the Tax Court held that earnings or profits should be reduced by cost rather than the lower, fair market value. See Beach Petroleum Corp., 5 CCH T.C.M. 638 (1946), *semble,* where fair market value exceeded cost. In Reynolds Spring Co. v. Commissioner of Internal Revenue, 181 F. 2d 638 (C.A. 6), cert. denied, 340 U.S. 821 (1950), another depreciated property distribution, cost rather than the lower, fair market value was used to reduce equity invested capital for purposes of the excess profits tax. *Cf.* Charles Leich & Co. v. United States, 210 F. 2d 901 (C.A. 7, 1954). The concurrence in Guinness v. United States, 73 F. Supp. 119, 132-134 (Ct. Cl. 1947), cert. denied, 334 U.S. 819 (1948), is in agreement with our theory and result in treating a distribution of appreciated property. The majority disposed of the case on the theory of Commissioner of Internal Revenue v. Court Holding Co., 324 U.S. 331 (1945). Commissioner of Internal Revenue v. Wakefield, 139 F. 2d 280 (C.A. 6, 1943), and Binzel v. Commissioner of Internal Revenue, 75 F. 2d 989 (C.A. 2), cert. denied, 296 U.S. 579 (1935), reach our result upon different principles.

No purpose would be served by an extended discussion of the cases since we have set out above the two major

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[13]Nearly all of the cases are collected by Molloy, Some Tax Aspects of Corporate Distributions in Kind, 6 Tax L. Rev. 57 (1950).

theories that have competed for acceptance as the solution to our problem. With variations of language, the decisions espouse one or the other. The Tax Court's opinion in this case presents one view as well as we think it can be presented. For the reasons stated we think the other view is the better one.

After this opinion was prepared but before it was filed, the Second Circuit reached the same result upon the same theory in a case involving the same corporate distribution as is involved here. Commissioner of Internal Revenue v. Fannie Hirshon Trust, F.2d (C.A. 2, decided May 17, 1954).

The judgment of the Tax Court will be reversed and the cause remanded for proceedings in accordance with this opinion."

APPENDIX "B"

Judgment of the Court Below

UNITED STATES COURT OF APPEALS

FOR THE THIRD CIRCUIT

No. 11,202

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

ESTATE OF IDA S. GODLEY, Deceased, PAUL F. GODLEY and JOHN W. YOUNG, JR., Co-Executors,
Respondents.

ON PETITION TO REVIEW A DECISION OF THE TAX COURT OF THE UNITED STATES

Present: MARIS, KALODNER and STALEY, *Circuit Judges.*

JUDGMENT

This cause came on to be heard on the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby reversed, and the cause remanded for proceedings in accordance with the opinion of this Court.

Attest:

IDA O. CRESKOFF
Clerk

May 28, 1954

(RECEIVED & FILED MAY 28, 1954
IDA O. CRESKOFF, Clerk)

APPENDIX "C"

Statutes and Regulations Involved

Internal Revenue Code of 1939:

26 U. S. C. 1946 ed., Sec. 115:

"§ 115. *Distributions by corporations*

"(a) *Definition of Dividend.*—The term 'dividend' when used in this chapter . . . means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made . . ."

* * * * *

"(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113 . . ."

"(d) *Other Distributions from Capital.*—If any distribution made by a corporation to its shareholders is not out

of increase in value of property accrued before March 1, 1913, and is not a dividend, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property. This subsection shall not apply to a distribution in partial or complete liquidation or to a distribution which, under subsection (f)(1), is not treated as a dividend, whether or not otherwise a dividend."

* * * * *

"(j) *Valuation of Dividend.*—If the whole or any part of a dividend is paid to a shareholder in any medium other than money the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder."

* * * * *

Treasury Regulations 111:

SEC. 29.115-1. *Dividends.*

* * * * * *

"The term 'dividend' does not include * * *. In all other cases the term includes any distribution to shareholders to the extent made out of accumulated or current earnings or profits.

* * * * *

Section 29.115-2

"Sources of Distributions in General.—For the purpose of income taxation every distribution made by a corporation is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits. In determining the source of a distribution,

consideration should be given *first,* to the earnings or profits of the taxable year; *second,* to the earnings or profits accumulated since February 28, 1913, only in the case where, and to the extent that, the distributions made during the taxable year are not regarded as out of the earnings or profits of that year; *third,* to the earnings or profits accumulated prior to March 1, 1913, only after all the earnings or profits of the taxable year and all the earnings or profits accumulated since February 28, 1913, have been distributed; and *fourth,* to sources other than earnings or profits only after the earnings or profits have been distributed.

If the earnings or profits of the taxable year (computed as of the close of the year without diminution by reason of any distributions made during the year and without regard to the amount of earnings or profits at the time of the distribution) are sufficient in amount to cover all the distributions made during that year, then each distribution is a taxable dividend. (See section 29.115-1.) If the distributions made during the taxable year exceed the earnings or profits of such year, then that proportion of each distribution which the total of the earnings or profits of the year bears to the total distributions made during the year shall be regarded as out of the earnings or profits of that year. The portion of each such distribution which is not regarded as out of earnings or profits of the taxable year shall be considered a taxable dividend to the extent of the earnings or profits accumulated since February 28, 1913, and available on the date of the distribution. In any case in which it is necessary to determine the amount of earnings or profits accumulated since February 28, 1913, and the actual earnings or profits to the date of

a distribution within any taxable year (whether beginning before January 1, 1936, or, in the case of an operating deficit, on or after that date) cannot be shown, the earnings and profits for the year (or accounting period, if less than a year) in which the distribution was made shall be prorated to the date of the distribution not counting the date on which the distribution was made. The provisions of this section may be illustrated by the following example:

Example. At the beginning of the calendar year 1942, the M Corporation had $12,000 in earnings and profits accumulated since February 28, 1913. Its earnings and profits for 1942 amounted to $30,000. During the year it made quarterly distributions of $15,000 each. Of each of the four distributions made, $7,500 (that portion of $15,000 which the amount of $30,000, the total earnings and profits of the taxable year, bears to $60,000, the total distributions made during the year) was paid out of the earnings and profits of the taxable year; and of the first and second distributions, $7,500 and $4,500, respectively, were paid out of the earnings and profits accumulated after February 28, 1913, and prior to the taxable year, as follows:

Distributions During 1942		Portion out of Earnings or Profits of the Taxable Year	Portion out of Earnings Accumulated Since Feb. 28, 1913, and Prior to Taxable Year	Taxable Amount of Each Distribution
Date	Amount			
March 10	$15,000	$7,500	$7,500	$15,000
June 10	15,000	7,500	4,500	12,000
September 10 ..	15,000	7,500	—	7,500
December 10 ..	15,000	7,500	—	7,500
Total amount taxable as dividends				$42,000

Any distribution by a corporation out of earnings or profits accumulated prior to March 1, 1913, or out of in-

crease in value of property accrued prior to March 1, 1913 (whether or not realized by sale or other disposition, and, if realized, whether prior to or on or after March 1, 1913), is not a dividend within the meaning of chapter 1."

* * * * *

"SEC. 29.115-4. *Distributions other than a dividend.*— Under Section 115(d), any distribution * * * other than (1) a dividend * * * shall be applied against and reduce the adjusted basis of the stock provided in Section 113 and shall be taxable to the recipient if, and to the extent that, such distribution exceeds such basis. * * *"

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In the Supreme Court of the United States

OCTOBER TERM, 1954

No. 305

ESTATE OF IDA S. GODLEY, DECEASED, PAUL F. GODLEY AND JOHN W. YOUNG, CO-EXECUTORS, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 3a-20a) are reported at 19 T. C. 1082. The opinion of the Court of Appeals (Pet. App. 17-28) is reported at 213 F. 2d 529.

JURISDICTION

The judgment of the Court of Appeals was entered on May 28, 1954. (Pet. App. 29.) The peti-

tion for a writ of certiorari was filed August 25, 1954. The jurisdiction of this Court is invoked under 28 U. S. C., Sec. 1254.

QUESTION PRESENTED

Whether the entire fair market value of a corporate distribution of property in kind to shareholders is taxable to the shareholders as a dividend under Section 115 of the Internal Revenue Code where the distributing corporation's earnings and profits (without increase in the amount of the appreciation in value of the distributed property) are more than sufficient to cover the adjusted cost of the distributed property to the distributing corporation but are not sufficient to cover the full fair market value (cost plus appreciation in value) of the property at the time of the distribution.

STATUTE INVOLVED

Internal Revenue Code of 1939:

> SEC. 22. GROSS INCOME.
>
> (a) *General Definition.*—"Gross income" includes gains, profits, and income derived from * * * dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from * * * dividends, * * * or gains or profits and income derived from any source whatever. * * *
>
> * * * * * *

(e) *Distribution by Corporations.*—Distributions by corporations shall be taxable to the shareholders as provided in section 115.

* * * * *

(26 U. S. C. 1952 ed., Sec. 22.)

SEC. 115. DISTRIBUTION BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made. * * *

(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against

and reduce the adjusted basis of the stock provided in section 113. * * *

* * * * *

(d) [as amended by Sec. 214 (b) of the Revenue Act of 1939, c. 247, 53 Stat. 862] *Other Distributions from Capital.*—If any distribution made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not a dividend, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property. This subsection shall not apply to a distribution in partial or complete liquidation or to a distribution which, under subsection (f)(1), is not treated as a dividend, whether or not otherwise a dividend.

* * * * *

(j) *Valuation of Dividend.*—If the whole or any part of a dividend is paid to a shareholder in any medium other than money the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder.

* * * * *

(26 U. S. C. 1952 ed., Sec. 115.)

STATEMENT

The facts were all stipulated (R. 21a-29a) and restated in detail by the Tax Court in its findings of fact (R. 4a-9a). The essential facts may be briefly summarized as follows:

The case involves the 1947 income tax liability of Ida S. Godley, a resident of New Jersey, who died on February 9, 1952. She was the owner of 200 shares of the outstanding common stock of Southern Natural Gas Company (hereinafter called Southern), a Delaware corporation which operates an interstate natural gas pipeline system and has its principal offices at Birmingham, Alabama. During 1947 the decedent received, as her proportionate share of distributions from Southern, cash in the total amount of $300 and 200 shares of the common stock of Southern Production Company, Inc. (hereinafter called Southern Production) which had a fair market value of $6.375 a share. Of the total amount of $1,575 represented by the cash and fair market value of the property, the decedent reported $740.25 in her 1947 income tax return as taxable distributions. The Commissioner determined that the decedent had understated her dividends and that the total distributions were 100 per cent taxable.[1] (R. 4a-5a, 6a.)

[1] The Commissioner informed Southern, by letter dated March 25, 1952, that the 1947 distributions of Southern were 100 per cent taxable as being "ordinary dividends" to the extent of 51.13562 per cent and "other income" to the extent of the remaining 48.86438 per cent (R. 5a-6a) but in his deficiency notice the Commissioner treated the entire amount of the distributions as dividends (R. 5a, 22a).

Southern had $5,674,586.32 in earnings and profits available for dividends in 1947. Its total distributions to shareholders in 1947 amounted to $2,113,722.03 in cash and 1,409,162 shares of the common stock of Southern Production. The Southern Production stock had an adjusted basis in Southern's hands of $3,199,950 and a fair market value at the time of distribution of $8,983,407.75. Subtraction of the cash distributions from Southern's earnings and profits of $5,674,586.32 leaves $3,560,864.29, an amount which is more than the adjusted cost basis of the distributed Southern Production stock but less than the fair market value of such stock. (R. 5a, 8a-9a.)

In declaring the Southern Production stock as a dividend in kind, the board of directors of Southern directed that the cost of the stock to the company be charged to earned surplus on the company's books of account. On its books Southern in 1947 charged earned surplus with $2,113,722.03 as representing the cash distributed as dividends during the year and $3,199,663.55 as representing the cost to it of the Southern Production stock distributed as a dividend. After making such deductions, Southern's book earned surplus was $12,356,597.65. (R. 7a-8a.)

In interpreting and applying Section 115 of the Internal Revenue Code, the Tax Court held that the $8,983,407.75 fair market value of the distributed Southern Production stock (cost plus the appreciation in value) should be charged against Southern's earnings and profits (without increase in the amount of the appreciation in value of the

distributed property) in determining to what extent the fair market value of the distributed stock constituted a dividend to the shareholders. The result was a holding that the $8,983,407.75 fair market value of the distributed stock is taxable to the shareholders as a dividend only to the extent of Southern's earnings and profits of $3,560,864.29 remaining after subtraction of the amount of Southern's 1947 cash distributions. (R. 9a-20a.)

The Court of Appeals reversed the Tax Court, holding that the cost basis of the distributed stock, rather than its fair market value, should be charged against Southern's earnings and profits in determining the extent to which the distributed stock constituted a dividend and that, since Southern's earnings and profits were more than sufficient to cover such cost basis, the entire stock distribution constituted a dividend on which the shareholders are taxable at fair market value. (Pet. App. 17-28.)

ARGUMENT

The present case and *Commissioner* v. *Hirshon Trust,* 213 F. 2d 523 (C. A. 2d), in which a petition for a writ of certiorari is also now pending (No. 286, October Term, 1954), involve the same corporate distribution. The decision below was rendered after the Second Circuit's *Hirshon Trust* decision but the court below independently reached the same result as the Second Circuit.[2]

[2] The present case was argued before the *Hirshon Trust* case and the opinion below (Pet. App. 28) states that "After this opinion was prepared but before it was filed" the Second Circuit in the *Hirshon Trust* case reached the same result upon the same theory.

As reasons for granting the writ, taxpayer asserts that the case involves an important question which should be settled by this Court and that the decision below is in conflict with *Palmer* v. *Commissioner*, 302 U. S. 63, and *Commissioner* v. *Timken*, 141 F. 2d 625 (C. A. 6th). (Pet. 6-15) The same conflicts were asserted in the *Hirshon Trust* petition and are non-existent, as we showed in our brief in opposition in that case, to which we respectfully refer the Court.[3] The importance of the question presented is urged on the basis of a related question or questions not presented in this case (Pet. 6-10) and on the legislative interpretation of provisions of the Internal Revenue Code of 1954 (Pet. 10-11), neither of which make the question here presented an important one requiring a decision by this Court. See our brief in opposition in the *Hirshon Trust* case.

Unlike the Hirshon Trust, taxpayer does not assert that the law on the question presented was previously well settled contrary to the decision below. Instead, taxpayer assumes there was a lack of litigation on the question and explains it by stating that the Commissioner had agreed that a corporate distribution of property to shareholders constitutes a dividend only to the extent that the fair market value of the property is covered by earnings and profits. (Pet. 7-9.) In support of that statement taxpayer cites two decisions (*Binzel*

[3] The *Hirshon Trust* petition alleges an additional conflict with *Timberlake* v. *Commissioner*, 132 F. 2d 259 (C.A. 4th), which we show is also non-existent.

v. *Commissioner*, 75 F. 2d 989 (C. A. 2d), certiorari denied, 296 U. S. 579; *Commissioner* v. *F. J. Young Corp.*, 103 F. 2d 137 (C. A. 3d)) which are not conclusive one way or the other as to the Commissioner's prior position and which, moreover, were rendered by the same Courts of Appeals which accepted the Commissioner's position in the present case and in the *Hirshon Trust* case.[4] The Commissioner's previous position was that the fair market value of the distributed property should be applied against earnings and profits *as increased* in the amount of the appreciation in value of the distributed property, as is evident from the Tax

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[4] *Binzel* was an early case in which the Commissioner argued that a corporate distribution of property constituted a dividend if the fair market value of the distributed property was covered by earnings and profits and that, since the record was silent as to the amount of the distributing corporation's earnings and profits, it must be assumed that the corporation had sufficient earnings and profits to cover the distribution. The Second Circuit held that the distribution was a dividend whether it was regarded as made out of earnings and profits because the property was originally purchased out of earnings or profits or whether the taxpayer had earnings and profits to cover the market value of the distributed property. In our brief in opposition to certiorari (No. 66, October Term, 1935) we argued (p. 4) that, even if the excess of the fair market value of the distributed property over cost was not attributable to earnings and profits apart from the increase in value of the property, the distribution would still be a taxable dividend.

The *F. J. Young Corp.* case involved a distribution which was to a large extent out of "unrecognized" gain realized by the distributing corporation on a tax-free exchange and the question argued and decided was whether the unrecognized gain constituted earnings and profits. The Third Circuit held that it did. The exact contrary is now provided in Section 115(l) of the Code of 1939, as added by Section 501 (a) of the Second Revenue Act of 1940, c. 757, 54 Stat. 974.

Court decisions cited in the *Hirshon Trust* petition. That position was rejected. The Commissioner's present position is not only consistent with but is the logical consequence of rejection of that position, as the court below indicated (Pet. App. 23-24) and as was stated in our brief in opposition in the *Hirshon Trust* case.

CONCLUSION

The decision below is correct and involves no conflict of decisions or important questions requiring review. The petition for a writ of certiorari should be denied.

Respectfully submitted,

SIMON E. SOBELOFF,
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H. BRIAN HOLLAND,
Assistant Attorney General.
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OCTOBER TERM, 1954

No. 305

ESTATE OF IDA S. GODLEY, Deceased, PAUL F. GODLEY and JOHN W. YOUNG, JR., Co-Executors,
Petitioners,

—against—

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

REPLY BRIEF FOR PETITIONERS

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1. The Commissioner's brief in the *Godley* case.

The Commissioner relies upon his brief in the *Hirshon Trust* case as setting forth his views with respect to the importance of the question presented, the relevancy of the Internal Revenue Code of 1954 and the asserted conflict between *Palmer* v. *Commissioner,* 302 U. S. 63, and *Commissioner* v. *Timken,* 141 F. 2d 625 (C. A. 6) (Commr's brief p. 8).

The additional matter contained in the Commissioner's brief in the *Godley* case is with reference to our explanation for the lack of litigation over the question whether it was necessary for the fair market value to be covered by earnings or profits in order that the distribution might be a taxable dividend to the extent of fair market value.

The Commissioner professes to believe that his "previous position was that the fair market value of the distributed property should be applied against earnings and profits as *increased* in the amount of the appreciation in value of the distributed property * * *" and that "Commissioner's present position is not only consistent with but is the logical consequence of rejection of that position as the Court below indicated (Pet. App. 23-24) * * *"

The Commissioner draws a long bow with respect to his former and his present position.

(a) The Former Position.

In neither of the cases cited in our petition (p. 8), *Young* v. *Commissioner,* 103 F. 2d 137 (3rd Cir. 1939) or in *Binzel* v. *Commissioner,* 75 F. 2d 989 (2d Cir.) cert. denied 296 U. S. 579 (1935) did the Commissioner contend that earnings or profits should be increased in the amount of the unrealized appreciation in value of the asset distributed.

Young v. *Commissioner* was like *Equitable Securities Corporation,* decided June 23, 1954 (1954 CCH Par. 9530) referred to in the Commissioner's brief in the *Hirshon Trust* case p. 15. In both these cases the question was whether a corporation which received a distribution of appreciated property was entitled to a dividends received credit to the extent of fair market value or only to the extent of earnings or profits.

The Commissioner contended under Section 115 (d) that the distribution was not a dividend except to the extent of earnings or profits and that the stockholders were liable to capital gains taxes to the extent that the fair market value of the distribution exceeded earnings or profits and the basis at which they held their stock. The Commissioner did not argue that earnings or profits should be increased by the amount of the appreciation. Such an argument would

have destroyed the basis for his claim. The Commissioner was defeated by the Court of Appeals for the Third Circuit in the *Young* case by that Court's determination that earnings or profits were increased by the amount of the appreciation realized but unrecognized on a tax-free exchange. The fact, referred to by the Commissioner, that Congress amended the law by adding Section 115(1) expressly providing that earnings or profits should not include realized but not recognized gain merely emphasizes the point that Congress looked upon earnings or profits as measuring the extent to which a distribution could be a taxable dividend.

In the *Binzel* case, the Commissioner did not argue that earnings or profits should be increased by the amount of the unrealized appreciation. There, the taxpayer contended that the property distribution was out of earnings or profits only to the extent of cost and that under Section 115(d) the amount of the appreciation, not being out of earnings or profits, was applicable to reduce the basis at which he held his stock. The Commissioner contended that if earnings or profits *from any source* were sufficient to cover the fair market value of the asset distributed, the distribution was out of earnings or profits to the extent of fair market value under Section 115(b) of the Code. This contention was sustained by the Court.

The motivating force behind the argument that earnings or profits should be increased in the case of individuals, was to increase the amount of the distribution which was taxable as a dividend and to decrease the amount which was applicable under Section 115(d) to reduce basis.

(b) The Present Position.

The Commissioner's present position is that Section 115(d) is applicable only to distributions which impair the

capital of the corporation. This contention was submitted to the Tax Court for the first time in the *Godley* case in support of Mr. McLarney's theory that the difference between earnings or profits and fair market value was not applicable to reduce basis under Section 115(d) but was taxable to the stockholders as "other income" under Section 22(a). The "other income" contention was rejected by the Tax Court and was abandoned in the appeals by the Commissioner to the Second and Third Circuits. On the appeals, the Commissioner nevertheless adhered to his new position that Section 115(d) had no application to distributions which did not impair capital. This view was accepted by the Court of Appeals for the Second Circuit. The learned judges who composed the Court (Harlan, Clark and Hincks) were thoroughly grounded in principles of corporate law but, it is believed, had had little experience with respect to income taxes. They were confronted with the interpretation of the word "dividend", the phrase "earnings or profits" and the caption to Section 115(d) "Other Distributions from Capital" and by an argument by the Commissioner which the Court paraphrased as follows:

> "The Commissioner's position is that all that is excluded from individual income taxation under § 115 are distributions to shareholders which impair the capital of the distributing corporation. * * * Therefore, it is contended, once it is shown that a distribution in kind has left the corporate capital intact, the distribution is 'out of the corporation's earnings or profits' and hence a dividend under § 115(a) which under § 115(j) becomes taxable to the shareholders to the full extent of its market value at the time of receipt."

The Court relied upon the caption to Section 115(d) "Other Distributions from Capital" as indicating the scope of the section and held that it was "designed to subject to capital gains taxation those distributions which had left the capital of the corporation impaired."

The Court of Appeals for the Third Circuit did not expressly interpret Section 115(d) as applicable only to distributions which impaired the corporation's capital. But the Court thought that if earnings or profits were charged with the fair market value of the asset distributed, instead of the cost, the effect would be to produce a capital impairment on the corporate books. Section 115(d) has no relation to the corporate books. It is part of a taxing statute. It plainly provides, in effect, that if the distribution received by the stockholders in cash or in property is in excess of earnings or profits, computed for tax purposes, the excess is applicable to reduce the basis at which the stockholders hold their stock, and to the extent that the distribution is in excess of basis, such excess is taxable to them as capital gain.

The difference between the former position of the Commissioner and his present position in the *Godley* and *Hirshon Trust* cases is this: Formerly the Commissioner interpreted Section 115(d) as applicable to all distributions in cash or in property whether out of corporate earned surplus, paid-in surplus, capital surplus, revaluation surplus or out of capital which were in excess of earnings or profits computed for tax purposes as applicable to reduce basis under Section 115(d) and to the extent in excess of basis, as subject to capital gain treatment.

The present position of the Commissioner is that it is not necessary for earnings or profits to cover the fair market

value of the asset distributed in order that the distribution may be a dividend to the extent of fair market value. In order to reach this result, the Commissioner interprets Section 115(d) as not applicable, except to distributions which are out of capital. This contention puts a gloss upon the phrase "earnings or profits" in Section 115(a) so that the phrase "earnings or profits" in Section 115(a) is treated as differentiating distributions out of earnings from those out of capital. Once it is determined that the distribution is not out of capital because earnings or profits are sufficient to cover the cost of the asset distributed, then the distribution becomes a "dividend" for tax purposes, which is valued in the hands of the stockholders at fair market value.

The present position of the Commissioner has no relation to his former contention which was a straightforward attempt to increase the coverage of property distributions by increasing earnings or profits with full recognition of the fact that to the extent that the fair market value of the distribution was not covered by earnings or profits, it was not a dividend and was applicable to reduce the basis at which stockholders held their stock.

2. The Commissioner's Brief in the *Hirshon Trust* Case.

(a) The Importance of the Question Presented.

Although the Commissioner's brief in the *Godley* case refers us to his brief in the *Hirshon Trust* case as to the importance of the question presented (p. 8), the brief in the *Hirshon Trust* case contains no discussion of the importance of the question but merely asserts on the basis of a most inadequate presentation that the result reached by the courts below was clearly correct.

The result reached by the courts below was that the proper way to tax a distribution in kind of appreciated property was to charge earnings or profits with the cost of the asset distributed and, if earnings or profits were sufficient to cover cost, to tax the distribution to the stockholders as ordinary income at fair market value. There is no provision in the Code which clearly imposes a tax on this basis. It is apparent that the question is important. Nothing could show this more clearly than the Commissioner's statement (p. 15) that if the Court denies the petitions for writs of certiorari in these cases, the Government will dismiss its appeal in the *Equitable Securities Corporation* case. We have been admonished by repeated decisions of this Court that the denial of an application for certiorari does not indicate any view by this Court as to the merits of the question presented. If this Court denies certiorari, what justification is there for the Commissioner's dismissing his appeal in the *Equitable Securities Corporation* case? It is submitted that the Government is clearly entitled to the tax which was imposed in the *Equitable Securities* case.

We disagree completely with the thought that it is important that the Commissioner be consistent with respect to his contentions. From the standpoint of taxpayers, the important thing is to have any point raised by the Commissioner settled. The confusion which now exists with respect to the law applicable to distributions of appreciated or depreciated property in kind could have been cleared up long ago if the Commissioner, instead of dismissing appeals from controlling cases, had prosecuted appeals to final conclusion. One very strong reason for granting certiorari in this case is to enable this Court to decide on the merits whether the decisions of the lower courts are right before the Commis-

sioner dismisses his appeal in the *Equitable Securities Corporation* case.

(b) The Revenue Act of 1954.

We have included the relevant provisions of the 1954 Code as an appendix to this reply brief.

The statement in the Commissioner's brief (*Hirshon Trust* Brief, p. 14) that these provisions do not "of course have any bearing on the instant case" is in error. As we stated in our petition (p. 11) subsequent legislation may be considered to assist in the interpretation of prior legislation on the same subject.

The Commissioner states in a footnote (*Hirshon Trust* Brief, p. 14):

> "However, inconsistently with the logical conclusion that a property distribution is out of earnings and profits, and therefore a dividend in its entirety, when earnings and profits are sufficient to cover the cost basis of the distributed property, the examples in the committee reports on the 1954 Code referred to by taxpayer (Pet. 12) reflect that the amount of the dividend to the shareholders would be limited to the amount of the earnings and profits prior to the distribution. It would seem that the language of the 1954 Code would control over the legislative reports, but that is a problem for the future."

We agree with the Commissioner that logically the effect upon earnings or profits ought to correspond with the amount of earnings or profits deemed distributed by a property distribution. It is clear from Section 301(b) of the 1954 Code that the fair market value of the property distributed is charged against earnings or profits. It is also

clear from Section 301(c) that the portion of the distribution which is out of earnings or profits is included in gross income and the portion of the distribution which is not out of earnings and profits is applied against and reduces the basis of the stock. Section 316 contains the provision that "every distribution is made out of earnings and profits to the extent thereof * * *". Section 115(j) is eliminated, except to the extent that it requires the fair market value of the asset to be charged against earnings or profits for the purpose of determining the extent to which the distribution is a dividend. With this interpretation, Section 115(j) now becomes part of Section 301(b).

Section 312 applies only to the reduction in earnings or profits for the purpose of computing earnings or profits available for subsequent distribution. It has no application to the provisions of the new Act which govern the taxability of the property distribution to stockholders. The effect of this provision is to subject to the possibility of double taxation that portion of earnings or profits which is in excess of cost and which was deemed distributed by the property distribution.

(c) The Conflict with *Palmer* v. *Commissioner*, 302 U. S. 63.

The Commissioner says (p. 13):

> "* * * the court below decided the amount of the reduction in earnings and profits on the facts of this case, not that a reduction in earnings and profits is always a prerequisite to a dividend."

We are unable to understand how a distribution can be said to be "out of earnings or profits" and therefore a

dividend if earnings or profits are not reduced by the distribution. In the *Palmer* case this court looked upon a bargain sale to stockholders as effecting a distribution of earnings or profits and necessarily a reduction of them up to the extent of the difference between the value of the asset sold and the price received.

(d) The Conflict with *Commissioner* v. *Timken*, 141 F. 2d 625 (C. A. 6).

The Commissioner asserts that in the *Timken* case there was a distribution of capital, rather than a dividend, because at the time of the distribution the corporation had no earnings and profits to distribute, and contends that the decision of the Court below is not in conflict "with the general proposition that a dividend does not result from a distribution of property by a corporation which has no earnings or profits at the time of the distribution" (p. 12).

Logically under the decision of the Court of Appeals in the *Hirshon Trust* case, if a corporation has a deficit in earnings or profits, the cost of the asset distributed merely increases the deficit, but the appreciation in value is taxable to stockholders as ordinary income. This view was taken by Mr. Raum in his article "Dividends In Kind: Their Tax Aspects" 63 Harv. L. Rev. 593. In a footnote (p. 610) Mr. Raum states that a more difficult problem arises where the distributing corporation's earnings and profits, determined without regard to the distribution, are less than its adjusted basis for the asset. The solution which he recommends is that to the extent that the appreciation is not out of capital, the correct answer "consistent with the argument advanced in the text would seem to be that the entire $5,000 (the amount of the appreciation) is a dividend." And he adds:

"The same result, with respect to the appreciation, would follow where the distributing corporation had a capital deficit."

Moreover, the *Timken* case applied Section 115(d) to the distribution, although the distribution did not impair the capital of the corporation. The Court in the *Timken* case said (p. 630):

> "The Investment Company was not in process of liquidation in 1936 and no change was made in its capital during that year. Its stock was not impaired in that year since its surplus was in excess of the par value thereof."

The Court in the *Timken* case interpreted Capital for tax purposes as meaning any distribution which was not out of earnings or profits computed for tax purposes. Accordingly, the distribution was out of capital for tax purposes although it was covered by surplus. The decisions of both courts below are inconsistent with the *Timken* case. The Court of Appeals for the Second Circuit attempted to distinguish the *Timken* case upon the grounds suggested by the Commissioner, but the Court of Appeals for the Third Circuit made no such attempt (Pet. App. p. 21).

Respectfully submitted,

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APPENDIX

Internal Revenue Code of 1954

"SEC. 301. DISTRIBUTIONS OF PROPERTY.

[Sec. 301(a)]

(a) IN GENERAL.—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317 (a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

[Sec. 301(b)]

(b) AMOUNT DISTRIBUTED.—

(1) GENERAL RULE.—For purposes of this section, the amount of any distribution shall be—

(A) NONCORPORATE DISTRIBUTEES.—If the shareholder is not a corporation, the amount of money received, plus the fair market value of the other property received.

[Sec. 301(c)]

(c) AMOUNT TAXABLE.—In the case of a distribution to which subsection (a) applies—

(1) AMOUNT CONSTITUTING DIVIDEND. — That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

(2) AMOUNT APPLIED AGAINST BASIS.—That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.

(3) AMOUNT IN EXCESS OF BASIS.—

(A) IN GENERAL.—Except as provided in subparagraph (B), that portion of the distribu-

tion which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property."

"[Sec. 312(a)]

(a) GENERAL RULE.—Except as otherwise provided in this section, on the distribution of property by a corporation with respect to its stock, the earnings and profits of the corporation (to the extent thereof) shall be decreased by the sum of—

(1) the amount of money,

(2) the principal amount of the obligations of such corporation, and

(3) the adjusted basis of the other property, so distributed."

"[Sec. 316(a)]

(a) GENERAL RULE.—For purposes of this subtitle, the term 'dividend' means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. * * *"